

ERCST's position paper on free allocation adjustments due to activity level changes in phase 4 of the EU ETS

The European Roundtable on Climate Change and Sustainable Transition (ERCST) welcomes the opportunity to **respond to the public consultation regarding the implementing act on free allocation adjustments due to activity level changes.**

Developing robust rules for dynamic allocation is an important piece of the puzzle in making the EU ETS function properly, as it ensures better alignment between the supply and demand of allowances and limits the risk of under- or oversupplying installations that are perceptive to carbon leakage, thus reducing the risk to carbon leakage or windfall profits.

As such, ERCST wants to welcome the provisions agreed upon for Phase 4 in the revision of Directive 2003/87/EC and the options laid out by the European Commission in this public consultation, which will significantly improve the capability of the ETS to respond to changes in activity levels compared to Phase 3.

ERCST believes that the level of free allocation should resemble activity levels as precisely as possible. The rules on free allocation adjustments should be made as dynamic as possible. This does not only translate in the fact that allocation adjustments should proportionately follow changes in activity levels, but also that the time-lag between measuring activity levels and applying adjustments should be as short as possible.

It is also important to highlight that these new requirements for operators to collect, verify and report their activity levels on a yearly basis will only entail a fairly minimized administrative burden. Indeed, many operators indicate that they already monitor and report their activity levels for other purposes, often in an automated manner.

Dynamic allocation application and calculation

Building on the general principle outlined above, ERCST believes that allocation adjustments should proportionally follow the actual changes in activity level as closely as possible, once the initial threshold of 15% stipulated by Directive 2003/87/EC is reached. This implies that any increase or decrease beyond the 15% threshold should be reflected in a proportional adjustment (e.g. a decrease in activity of 17% should lead to an adjustment of 17% of allocation).

Regarding the start of the collection of activity level data and the calculation and timing of the first adjustment, ERCST wants to stress that the time-lag between the calculation of the two-year rolling average and the application of the allocation adjustment should be as short as possible, and that the first adjustments should start from the first year of Phase 4.

This would translate in the adjustment taking place in year x based on the two-year rolling average of years $x-1$ and $x-2$, which is already implied in question 3 of the questionnaire for the public consultation. The first adjustment should take place in 2021 based on the rolling average of the activity level data from the years 2020 and 2019.

Moreover, it is not made explicit how frequent the rolling averages will be calculated or adjustments will take place. ERCST wants to stress that in order to make the EU ETS as dynamic as possible, both the calculation of rolling averages and any potential adjustment should take place every year during phase 4.

Use of Absolute thresholds

Both the recitals to Directive 2003/87/EC as well as the Commission's roadmap recognise the possibility of adopting additional absolute thresholds in light of free allocation adjustments due to activity level changes.

ERCST does not see the need to consider any minimum quantitative threshold that would have to be reached as a double requirement next to the 15% relative threshold and/or any subsequent threshold, in order for the level of free allocation to be adjusted. This is the reason we answered option c in question 2 of the public consultation. Adopting such an 'and' threshold would make the system less dynamic, while we do not see how it would significantly reduce the administrative burden.

However, adopting a quantitative threshold *as an alternative* to the relative threshold, which would trigger an adjustment even if the relative threshold of 15% is not reached, would make the system more dynamic. During Phase 3, an absolute threshold of 50.000 EUAs already exists in the context of assessing 'significant capacity extension' in light of physical changes, which can lead to additional free allocation for an installation.

In Phase 3, in accordance with decision 2011/278/EU, this threshold of 50.000 EUAs has to represent at least 5% of the sub-installation's allowances allocated for free. Given these requirements, it can theoretically only apply to a very limited number of installations. Moreover, this number is declining over Phase 3 as the amount of free allowances allocated is steadily decreasing in line with the linear reduction factor (LRF) and the benchmarks.

For Phase 4, ERCST supports adopting an additional absolute threshold to make free allocation adjustments more dynamic, both for increasing and decreasing activity levels. Ideally, the absolute threshold would be set as low as possible: the lower the threshold, the more dynamic the system will be, as more installations can theoretically reach the absolute threshold before the 15% relative threshold. For example, based on 2017 data, a 50.000 EUA's threshold would only be relevant for about 450 installations, while a 25.000 EUA's threshold can theoretically apply to 800 installations, and a 10.000 EUA's threshold to 1600 installations.

The absolute threshold itself should ideally also be made dynamic and decline over Phase 4, as a static one will gradually apply to fewer installations as benchmarks keep on declining and industry continues to decarbonise. This threshold could be pegged to a variety of indicators, the most obvious one being the LRF.

Verification and reporting of activity level data

ERCST is of the opinion that aligning the deadline for reporting verified activity level data with the deadline for submitting the verified emissions report, currently March 31st, as it would reduce their administrative burden.

However, since the allocation of allowances takes place before February 28th, aligning both reporting deadlines by March 31st would mean that the verified activity level data from year x-1 will only be known after the free allocation for year x has already been issued. This would create a time-lag of more than one year, making the system less dynamic and weakening its adaptability to changing economic conditions.

To address this issue, the issuance of free allocation could be pushed back from February 28th to after the verified activity levels have been reported or the deadline for the verified emissions report could be pushed forward to before February 28th. However, since both deadlines are explicitly mentioned (in Article 11(2) of Directive 2003/87/EC and Article 68(1) of Regulation 601/2012), either of these options would require revisiting legislation, which seems unlikely.

Alternatively, one could imagine a true-up mechanism being developed, as is done by the Californian emission trading system, which corrects the level of free allocation issued to operators by February 28th based on the verified activity levels later in the year.

Other aspects to take into consideration

ERCST wants to highlight that issues could arise for installations making use of a fall-back benchmark if their free allocation is directly aligned with changes in their activity level.

Free allocation for such installations is calculated by multiplying their historical fuel/heat consumption with the fuel/heat benchmark. This means that any reduction in consumption is automatically treated as a decrease in activity levels, and translated in a decrease in the amount of free allocation received (if the relative threshold is reached).

This means that consumption reductions thanks to efficiency gains will also lead to lower levels of free allocation, even if actual production does not decrease. Likewise, installations that become less efficient (consume more) would receive additional free allocation. For installations with product benchmarks, a comparable efficiency gain or loss does not result in free allocation changes.

This creates both perverse incentives and discourages investments in efficiency improvements. The implementing act should take this issue into account.

Further safeguards to prevent manipulation or abuse of the system

As a general comment, ERCST wants to highlight that operators should not make decisions on production volumes based on the rules of the EU ETS. Unfortunately, the use of minimum thresholds, both relative or absolute, to determine whether adjustments to free allocation should take place always has the potential to create such perverse incentives.

If, as implied by question 2 of the questionnaire for the public consultation, an absolute minimum threshold might be considered, this would contribute to the risk for perverse incentives that already exists due to the use of the 15% relative threshold.

However, by considering an absolute threshold that would trigger an adjustment regardless whether the relative threshold has been reached, this risk could be decreased.